Supreme Court, U. S.
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In The

Supreme Court of the United States

October Term, 1976

No. 77-195

WILLIAM TARASI, GEORGE SAMPAS and VIRGINIA HARRIGAN,

Petitioners,

vs.

PITTSBURGH NATIONAL BANK and S. ROBERT MIALKI,

Respondents.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

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Respondents.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

JURISDICTION

Your petitioners seek a writ of certiorari as authorized by 28 U.S.C. §1254(1) which provides that cases in the courts of appeal may be reviewed by this Court "By writ of certiorari

granted upon the petition of any party to any civil or criminal case, before or after rendition of judgment or decree."

OPINIONS BELOW

The final judgment in the form of an affirmance of the order of the United States District Court for the Western District of Pennsylvania granting the defendants summary judgment was entered by the Court of Appeals of the Third Circuit on May 9, 1977, thereby making this a timely case for petitioning for a writ of certiorari under 28 U.S.C. §2101(c) which authorizes "writ[s] of certiorari intended to bring any judgment or decree in the civil action, suit or proceeding before the Supreme Court for review" mandating application within 90 days after the entry of such judgment or decree.

QUESTIONS PRESENTED

1. Whether the equitable and affirmative defense of *in pari delicto* would, as a matter of law, bar all suits by injured investors against outsiders.

2. Whether the equitable and affirmative defense of *in pari delicto* should, as a matter of law, bar a suit by injured investors against insiders on whom they materially relied when the insiders possess a greater degree of culpability and more knowledge and sophistication.

3. Whether scienter is a necessary prerequisite to applying the *in pari delicto* defense in a case based on §10 of the 1934 Securities Exchange Act or Rule 10b-5 promulgated thereunder

and if so, whether the plaintiffs' conduct exhibited such an intent to defraud.

4. Whether the application of *in pari delicto* as a defense to a tipper's violation of the Securities Exchange Act of 1934 would thwart congressional intent.

STATUTES INVOLVED

15 U.S.C. §78j

> "It shall be unlawful for any person, directly or indirectly by the use of any means or instrumentality of interstate commerce or of the mails, or any facility of any national securities exchange —
>
> (a) To effect a short sale, or to use or employ any stop-loss order in connection with the purchase or sale, of any security registered on a national securities exchange, in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.
>
> (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may

prescribe as necessary or appropriate in the public interest or for the protection of investors." (June 6, 1934, ch. 404, §10, 48 Stat. 891).

17 C.F.R. §240.10b-5

"It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange —

(a) To employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which they are made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security." (Sec. 10; 48 Stat. 891; 150 U.S.C. 78j) (13 F.R. 8183 Dec. 22, 1948 as amended at 16 F.R. 728 Aug. 11, 1951).

15 U.S.C. §78t

"(a) Every person who, directly or indirectly, controls any person liable under any provision of this chapter or of any rule or regulation thereunder shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable, unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action.

(b) It shall be unlawful for any person, directly or indirectly, to do any act or thing which it would be unlawful for such person to do under the provisions of this chapter or any rule or regulation thereunder through or by means of any other person.

(c) It shall be unlawful for any director or officer of, or any owner of any securities issued by, any issuer required to file any document, report, or information under this chapter or any rule or regulation thereunder without just cause to hinder, delay, or obstruct the making or filing of any such document, report, or information." (June 6, 1934, ch. 404, §20, 48 Stat. 899; May 27, 1936, ch. 462, §49 Stat. 1379; Aug. 20, 1964, Pub. L. 88-467 §9, 78 Stat. 579).

STATEMENT OF THE CASE

This is a securities case, based on violation of Section 10b of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder. William Tarasi, George Sampas, and Virginia R. Harrigan (now Virginia Rooney) were induced to purchase shares in Meridian Industries, Inc. (Meridian) by the representations of S. Robert Mialki, an agent and officer and manager of the Verona, Pennsylvania branch of Pittsburgh National Bank.

This action is based on the plaintiffs' claim for losses sustained when they purchased shares of Meridian stock in reliance on various fraudulent misrepresentations which Mr. Mialki made concerning shares of Meridian and Paragon Plastics, Inc. (Paragon). Mr. Mialki actively misrepresented these stocks and also failed to reveal all material facts pertaining to them, thus, acting in a manner explicitly prohibited by Section 10b and Rule 10b-5.

The plaintiffs are three persons, two of whom were totally unfamiliar and indeed unaware of the existence of the federal securities laws. The other had but a knowledge of their existence. None of the three were sophisticated investors.

William Tarasi is an individual who completed only two years of high school. He has been engaged in the used car business and as a small general contractor, and intermittently in the sale, purchase, and development of real estate. On December 13, 1971, S. Robert Mialki placed an order with Butcher, Singer, Dean and Scribner on behalf of William Tarasi for 1,200 shares of stock in Meridian for 8¼ dollars a share.

There is a dispute between the parties to this suit as to the existence and content of conversations, meetings, and discussions between Messrs. Mialki and Tarasi. Mr. Tarasi states in his deposition that there were many dialogues at different places between himself and Mr. Mialki. According to Mr. Tarasi, the first discussion relating to Meridian and Paragon took place in November of 1971. Mr. Tarasi was then told that there would be a merger between Paragon and Meridian, that he would be advised as to the time he could purchase Meridian stock since Paragon stock was available only for certain individuals, and that officials of Pittsburgh National Bank were buying large quantities of Paragon stock.

In subsequent conversations, Mr. Tarasi claims that Mr. Mialki assured him that he could not lose and he personally could guarantee there would be no losses.

According to Mr. Mialki, these conversations did not take place and he merely placed the orders for Meridian stock on behalf of Mr. Tarasi. (Mr. Tarasi never received any stock. It was always held by the bank and Mr. Mialki.)

The plaintiff, Virginia Harrigan, is presently a housewife. She is the aunt of plaintiff William Tarasi. In February, 1972, she purchased 100 shares of Meridian common stock from Hornblower and Weeks-Hemphil, Noyes at 8⅞ dollars a share, for a total net price of $911.32.

There is a discrepancy between Virginia Harrigan and Mr. Mialki's sworn testimony. She asserts that Mr. Mialki assured her that Meridian stock was a good buy and that Pittsburgh

National Bank was behind it. He states that no such conversation ever took place.

George Sampas, a member of the Florida Bar, who graduated from law school in 1969, purchased a series of "calls" in regard to Meridian common stock from Walston and Company in April of 1972.

Mr. Sampas and Mr. Mialki are in agreement that a discussion did take place between them in December of 1971 in relation to the proposed merger between Meridian and Paragon. However, Mr. Mialki denies making any assurances whatsoever to Mr. Sampas.

Mr. Sampas contends that Mr. Mialki told him the merger would double the value of his Meridian stock and that executives of the bank were purchasing large blocks of Paragon stock.

An associate of Mr. Sampas purchased 1,000 shares through her margin account to hold for him. After they decreased in value, Mr. Sampas and Mr. Tarasi each purchased 500 of these shares so that she would not incur any loss.

Mr. Tarasi also voluntarily reimbursed Mrs. Harrigan for the losses she sustained in the transaction. Although he had not advised her directly, he did not want her to sustain any losses due to a relationship between herself and Mr. Mialki which his introduction of the two had fostered.

The plaintiffs-petitioners' basis for their cause of action for

fraudulent concealment rests substantially on the answers to the two sets of requests for admissions directed to the bank. A careful reading of the bank's answers to plaintiffs' first set of requests reveals that prior to the purchase of Meridian stock by any of the plaintiffs, Neal Hageal who was the principal shareholder, president and chief executive officer, and a director of Paragon, borrowed the sum of $200,000 from defendant bank on November 8, 1971. Mr. Hageal pledged to the bank 136,000 shares of his common stock in Paragon. The loan was personally guaranteed by Mr. Basil M. Briggs, the chief executive officer, chairman of the board of directors, and one of the principal shareholders in Meridian. Mr. Robert Mialki arranged and approved this loan. None of these material facts were disclosed at any time to any of the plaintiffs prior to the institution of the lawsuit.

According to the registration statements filed by Meridian with the Securities and Exchange Commission in 1972, Paragon had outstanding 498,226 shares of common stock (stated value $.10 per share). Mr. Hageal was the record owner of 338,605 shares of Paragon common stock. Under the terms of the proposed merger disclosed in those registration statements every 3.0061422 shares of Paragon would be exchanged for one share of Meridian's common stock ($.10 per share). Mr. Mialki failed to discuss any of the essential terms of the merger as well as to point out the contingencies involved in the deal.

Subsequent to the initial loan in 1971, the answers to the plaintiffs' requests for admission disclose that Neal Hageal entered into two loan transactions with defendant bank. On May 31, 1972, Mr. Hageal borrowed $6,000 and pledged to the

bank an additional 3,000 shares of his Paragon common stock. On June 26, 1972, he borrowed an additional $75,000 from the defendant bank and pledged to the bank an additional 30,000 shares of his Paragon stock. By mid 1972, the defendant bank was the pledgee of 169,000 shares of Paragon common stock. Mr. Briggs was the personal guarantor of the $275,000 in loans of Mr. Hageal from defendant bank. Under the Securities Exchange Act of 1934, the bank became initially in 1971 and continued through mid 1972 and thereafter to be a "controlling person" of Paragon which was under an agreement of January, 1972 to merge into Meridian. Considering the exchange ratio, the bank may also be deemed to be a "controlling person" in Meridian under Section 20(a) of the Security Exchange Act of 1934, 15 U.S.C. §78(t). This section clearly exemplifies Congress' intention that liability be based upon control and culpability.

In its answer to plaintiffs' second request for admissions the defendant bank admits the authenticity of a letter dated December 18, 1972, from Mr. M.T. McCann, assistant cashier of the defendant bank to Mr. C.L. Hapgood, Chief Loan Administrator of the Small Business Administration. Mr. Mialki was undoubtedly familiar with the financial relationship between Paragon and the Small Business Administration but he failed to reveal even the existence of the relationship to the plaintiffs.

The plaintiffs commenced an action in the United States District Court for the Western District of Pennsylvania in November, 1974, against Pittsburgh National Bank (bank) and S. Robert Mialki. In their complaint, the plaintiffs claim an aggregate loss of approximately $22,000 as a result of the fraudulent conduct of the defendant and their violation of the federal securities laws. Jurisdiction in that court was based

upon 15 U.S.C. §78aa which grants district courts' jurisidiction over violations of 15 U.S.C. §78 and rules and regulations promulgated thereunder.

Throughout the proceedings leading to the granting of summary judgment for the defendants-respondents, the plaintiffs were hampered in their preparation for litigation by the protective orders, both written and oral, issued from the bench and never signed or docketed by the Honorable Senior District Judge Joseph P. Willson. These were granted to the defendants in answer to plaintiffs' request for production and interrogatories.

On January 23, 1976, Pittsburgh National Bank filed a motion for summary judgment and on January 27, 1975, Robert Mialki proceeded to do the same. The plaintiffs then filed a brief in opposition to this motion. On May 20, 1976, a few days after the submission of the plaintiffs' brief, the Honorable Senior District Judge Joseph P. Willson signed an order granting summary judgment and handed down the court's memorandum of the law. This memorandum was an adoption of the bank's brief *in toto*. This brief was appended to the order and was used as the court's own opinion.

The plaintiffs then appealed this case to the United States Court of Appeals for the Third Circuit. On May 9, 1977, the Honorable Judge Arlin M. Adams handed down the opinion of a two-person court (Judge Kalodner having died in the time period between the argument and the disposition of the case). The court affirmed the lower court's decision.

This petition for a writ of certiorari follows.

REASONS FOR GRANTING THE WRIT

The writ of certiorari should issue in the present case for several reasons. A writ should properly issue because this Court has never addressed the issue whether *in pari delicto* should be permitted to act as a bar to all cases, as a matter of law, brought under the Securities Acts. This is an important federal question which should be, but has not been, decided by the Court. This is especially relevant in light of the fact that *in pari delicto* has been abolished as a defense to anti-trust cases by this Court's decision in *Perma Life Mufflers, Inc. v. International Parts Corp.*, 392 U.S. 134 (1967). The Third Circuit misconstrued the holding in that case in its disposition of the present case because it relied on dicta and concurring opinions and not on the court's own majority opinion.

Whether *in pari delicto* can be used as a defense is a significant question because this Court must determine how best to implement the federal securities laws. In *Perma Life,* Justice Black stated that the filing by the Court of Appeals, which allowed *in pari delicto* to be utilized as a defense, threatened the effectiveness of the private action as a vital means for enforcing federal policy as enacted by the laws of the land. This is analogous to the situation faced by this Court.

Furthermore, lower courts have been split in their determination of what conduct is necessary in order to place plaintiffs *in pari delicto.* The Fifth Circuit has held that the activity must be "mutual, simultaneous, and relatively equal" in comparison with that of the defendant in order to make him "active, essential, and knowing participants in the unlawful

activity" so as to make him *in pari delicto. Woolf v. S.D. Cohen and Company*, 515 F.2d 591, 604 (5th Cir. 1975); *cert. granted, vacated and remanded for consideration in light of T.S.C. Industries, Inc. v. Northway, Inc.*, 426 U.S. 438 (1976).

The Third Circuit in deciding the present case relied heavily on the Fifth Circuit's decision in *Kuehnert v. Texstar Corporation*, 412 F.2d 700 (5th Cir. 1969). This case held that a plaintiff tippee-purchaser was *in pari delicto* with the tipper as a matter of law. However, that decision was handed down six years prior to the same court's enunciation of a requirement of mutuality of conduct in *Woolf v. S.D. Cohen and Company, supra.*

The Tenth Circuit has held that a plaintiff who has become so enamoured with the merits of an investment through the defendant's misrepresentation that he induces others to buy an interest and in so doing violates a section of the Securities Exchange Act of 1934 does not forfeit his right to bring suit. There is no equal culpability and, therefore the parties are not *in pari delicto.* The court stated that the purpose of the 1934 Securities and Exchange Act was to protect the naive or uninformed investor. *Can-Am Petroleum Corp. v. Beck*, 331 F.2d 371 (10th Cir. 1964).

The District Court of the Southern District of New York has held that the potential for harm of the tipper so exceeds that of the tippee that *in pari delicto* is usually inapplicable. *Nathanson v. Weis, Voisin, Cannon, Inc.*, 325 F. Supp. 50 (S.D.N.Y. 1971).

It must, therefore, be left to this Honorable Court to resolve these conflicting decisions and decide whether *in pari delicto* should ever be a defense and, if so, what conduct is necessary in order to place the plaintiffs in the position of being *in pari delicto.*

This Honorable Court should also grant the writ of certiorari because a lower court has decided a federal question in a manner which conflicts with the applicable decisions of this Court. The Third Circuit has overlooked the requirements that scienter be found in order to find a violation of the Securities Laws, specifically Section 10 and 10b-5. Such requirement was set forth in the case of *Ernst and Ernst v. Hochfelder,* 425 U.S. 185 (1976). The lower court did not address this requirement when it viewed the plaintiff's conduct and in fact ignored the necessity that the plaintiffs possess a requisite degree of scienter in order to put them *in pari delicto* with the defendants.

The facts in this case show that the defendants acted in a fraudulent and dishonest manner in order to manipulate the stock market by inviting the plaintiffs to invest in Meridian stock and then increase the worth of their own holdings in Paragon. S. Robert Mialki did not even pay for his Paragon stock. This can be found on page 20 of Emma Dubac's deposition. (The records of the corporation show no payment was made, a fact that he never told the plaintiffs.) This is exactly the type of conduct which the Federal Securities Acts attempt to prohibit. The plaintiffs, on the other hand, were relatively innocent, unknowing investors who acted in a manner technically within the confines of 10b-5 but acted totally without scienter or the intention to defraud anyone. The obvious intent of S. Robert Mialki was to defraud William Tarasi, Virginia Harrigan and George Sampas.

This Court must, therefore, decide whether the plaintiffs' conduct in this case constituted the necessary and requisite degree of scienter which *Ernst and Ernst v. Hochfelder, supra,* implies that plaintiffs need be guilty of in order to be in a position of being *in pari delicto.*

In this case, if footnote 29 of the Third Circuit's Addendum Opinion is taken as the controlling law, neither William Tarasi, Virginia Harrigan nor George Sampas had the equal amount of knowledge, sophistication, or improper motive that was present in the case of S. Robert Mialki and the bank. It is to be noted quite clearly that these were unsophisticated investors, totally innocent in relation to Mr. Mialki who had all the pertinent information at his fingertips and who the record indicates did not even pay for his stock.

Furthermore, there was a considerable sum of stock pledged to the bank and it became the controlling person of Paragon and in fact also of Meridian under the appropriate case law that this Court and other courts have decided. We find that every facet of the Court's decision in *Ernst and Ernst v. Hockfelder, supra,* applies to Mr. Mialki. He is guilty of fraud and misrepresentation. This was not present in the situation involving William Tarasi, Virginia Harrigan and George Sampas. If scienter is required to prove a *prima facie* case under 10b-5 under this Court's rulings, how can *pari delicto* be a defense as to plaintiffs who are not guilty of the very elements necessary to prove a *prima facie* case against a defendant? *Pari*

delicto means in Latin "In equal fault." *Black's Law Dictionary*, 4th ed., p. 898. There is no equal fault in this case. The facts are clear on that.

There is a divison in the circuits. The decision of the Third Circuit has a chilling effect on the rights of innocent purchasers of stock who are relatively unsophisticated. Any defendant can achieve a perfect defense by the simple expediency of telling unsophisticated purchasers that this is inside information and don't spread it around. Thus, the tipper would be insulated completely from any liability for whatever fraudulent wrong he commits upon the investing public and especially the relatively innocent investing public who will be susceptible to the sophisticated fraudulent seller. The very words of "inside information" or "tip" mean nothing to the unsophisticated person but to the fraudulent, misrepresenting, scheming and conniving tipper would be the very defense that he would use to any suit. Therefore, the most sophisticated and the most fraudulent and most guilty tipper when passing on his tip would be insulated from any liability by simply passing on the information in letter form or in writing a memorandum or spoken words that this was inside information. Thus by that method he would protect himself completely from any lawsuit by the people that the law was designed to protect, the innocent unsophisticated investor.

The courts have repeatedly held that the sophisticated investors, the ones who are knowledgeable, do not need this type of protection. Certainly in the *Kuenhart* case which is relied upon by the Third Circuit it is quite clear that that investor was just as guilty, just as sophisticated, just as fraudulent as the

person who gave him the tip, and he was part of the scheme to defraud the public. That certainly is not the case here and this decision of the Third Circuit which is completely destructive of the rights of innocent investors should be reversed and these innocent investors be allowed to proceed to a trial on the merits. Summary judgment is a drastic remedy to be allowed to stand against these plaintiffs. To allow it to stand on these facts is a blot on the face of American jurisprudence.

The Supreme Court of the United States is the Court of last resort to which these plaintiffs can appeal for redress of their wrongs. They request respectfully that the Court grant this writ of certiorari so that they may be protected in their rights and that they may have what is guaranteed to them by the Constitution of the United States, a trial on the merits and not be deprived of their rights by the high-handed action that was present in this case. Here arguments were held when plaintiffs' counsel was not even present, protective orders were issued when he was not present, restrictions on discovery were issued when he was not present. This is contrary to any sense of fairness and justice. It is cases like this that tarnish the American system of jurisprudence and make the public say with one voice the words of William Shakespeare, "The first thing we do is kill all the lawyers."

We respectfully request that these plaintiffs be given their day in court so that the public will know that under our system of American jurisprudence even the small insignificant little investor who had no political clout and no economic strength and no financial backing as the Pittsburgh National Bank and S. Robert Mialki have, has his right to a fair hearing and a fair trial.

CONCLUSION

Wherefore, it is respectfully requested that this Court reverse the judgment of the Third Circuit in this case and remand this case for a trial on the merits.

Respectfully submitted,

s/ Louis M. Tarasi, Jr.

CONTE, COURTNEY AND TARASI
Attorneys for Petitioners

APPENDIX

APPENDIX A — JUDGMENT OF THE UNITED STATES COURT OF APPEALS

UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

No. 76-1834

WILLIAM TARASI, GEORGE SAMPAS, and VIRGINIA R. HARRIGAN,

Appellants

vs.

PITTSBURGH NATIONAL BANK and S. ROBERT MIALKI

(D.C. Civil No. 74-1078)

ON APPEAL FROM THE UNITED STATES DISTRICT COURT FOR THE WESTERN DISTRICT OF PENNSYLVANIA

PRESENT: ADAMS, KALODNER* and HUNTER, *Circuit Judges*

This cause came on to be heard on the record from the

* Judge Kalodner participated in the argument and conference in this appeal, but died before the filing of this opinion.

Appendix A

United States District Court for the Western District of Pennsylvania and was argued by counsel February 24, 1977.

On consideration whereof, it is now here ordered and adjudged by this Court that the judgment of the said District Court, entered May 20, 1976, be, and the same is hereby affirmed. Costs are taxed against the appellants.

ATTEST:

s/ M. Elizabeth Ferguson
Chief Deputy Clerk

May 9, 1977

APPENDIX A — OPINION OF THE UNITED STATES COURT OF APPEALS

UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

No. 76-1834

WILLIAM TARASI, GEORGE SAMPAS, and VIRGINIA R. HARRIGAN,

Appellants

vs.

PITTSBURGH NATIONAL BANK and S. ROBERT MIALKI

(D.C. Civil No. 74-1078)

On Appeal From the United States District Court for the Western District of Pennsylvania

BEFORE: ADAMS, KALODNER* and HUNTER, *Circuit Judges*

(Filed May 9, 1977)

Argued February 24, 1977

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Adams, *Circuit Judge.*

At issue in this appeal is whether the defense of *in pari delicto* stands as a bar to a lawsuit brought by "tippees" against a "tipper"[1] pursuant to section 10(b) of the Securities Exchange Act of 1934[2] and rule 10b-5[3] promulgated thereunder.

1. A "tipper" is a person who has possession of material inside information and who makes selective disclosure of such information for trading or other personal purposes. A "tippee" is one who receives such information from a "tipper." See 2 A. Bromberg, *Securities Law: Fraud, S.E.C. Rule 10b-5* at 190.7 (1973); 3 L. Loss, *Securities Regulation* 1450-51 (1961).

2. 15 U.S.C. §78j(b) (1970).

3. 17 C.F.R. §240.10b-5 (1975).

I.

Before reviewing the facts of this case, it is necessary to take note of the procedural posture of the litigation. Since this is an appeal from the grant of summary judgment for the defendants, we are obliged, of course, to consider the record in the light most favorable to plaintiffs. We then must determine whether the district judge erred in concluding that no issue of material fact remained and that defendants were entitled to a verdict as a matter of law.[4]

This suit was instituted in 1974 by William Tarasi, Virginia Harrigan and George Sampas against the Pittsburgh National Bank and S. Robert Mialki, an officer of the Bank and manager of its branch in Verona, Pennsylvania. The plaintiffs alleged that they purchased the stock of Meridian Industries, Inc. on the strength of information given to them by Mr. Mialki; that such information was false and misleading; and that the false and misleading information caused them to incur losses of $22,000.

Mr. Tarasi, a resident of the Pittsburgh area who operates a used car lot and a small contracting business, was the first of the plaintiffs who had contact with Mr. Mialki. Although he has dabbled in real estate speculation in both Pennsylvania and Florida, the record indicates that he has not had extensive experience with securities investments. In the course of his past business dealings, Mr. Tarasi had employed PNB as his bank

4. *See, e.g.,* Scott v. Plante, 532 F.2d 939 (3d Cir. 1976); Ransburg Electro-Coating Corp. v. Lansdale Finishers, Inc., 484 F.2d 1037 (3d Cir. 1973); Janik v. Celebrezze, 336 F.2d 828 (3d Cir. 1964).

and Mr. Mialki as his personal banker. As a result of the latter relationship, Mr. Tarasi and Mr. Mialki became friends, and had known each other for about five years before the incidents that led to this lawsuit.

Beginning in November of 1971, Mr. Tarasi alleged, Mr. Mialki had numerous discussions with him about two corporations: Meridian Industries and Paragon Plastics. According to Mr. Tarasi, Mr. Mialki stated that a merger between Meridian and Paragon was going to take place, that the Bank was behind the merger, and that "big shots" from the Bank were investing heavily in the securities of the two companies. Mr. Mialki indicated to Mr. Tarasi that it was too late to get on the Paragon "bandwagon," but that an investment in Meridian would still be a wise one. In particular, Mr. Mialki purportedly told Mr. Tarasi that Meridian common stock, which was then selling at eight dollars a share, would probably double in value because of the planned merger. Mr. Tarasi testified in his deposition that Mr. Mialki had represented that the data he was giving him was "hush-hush" and could not be repeated to anyone. In response to these disclosures, Mr. Tarasi purchased 1200 shares of Meridian common stock on the open market at 8¼ per share. Mr. Tarasi did not reveal, in connection with his purchase of Meridian stock, the information he had received about the planned merger between Meridian and Paragon.

The second plaintiff, Mrs. Harrigan, is an aunt of Mr. Tarasi.[5] According to the record, Mr. Tarasi asked Mr. Mialki

5. Subsequent to the events involved in this litigation, Mrs. Harrigan remarried. She is now known as Virginia Rooney.

for permission to inform Mrs. Harrigan that Meridian was a good investment opportunity. At a luncheon attended by Mrs. Harrigan, Mr. Tarasi and Mr. Mialki, the two gentlemen had a discussion about Meridian. When Mrs. Harrigan expressed interest, Mr. Tarasi recommended that she purchase shares in Meridian. Mr. Mialki made a general statement to the effect that Meridian was "good stock."

After the luncheon, Mrs. Harrigan proceeded to direct inquiries about Meridian to her regular banker and to a broker. Although the broker apparently recommended against purchasing the stock, Mrs. Harrigan said to him that she thought it would be a sound buy. Before acquiring the securities, however, she decided to speak to Mr. Mialki again. Another luncheon took place, at which time Mrs. Harrigan asked Mr. Tarasi whether Meridian was a sound investment. Mr. Tarasi said that Meridian was good stock and then gestured towards Mr. Mialki who added that the Bank was behind it. The record indicates, nonetheless, that the proposed merger between Paragon and Meridian was not mentioned to Mrs. Harrigan. Mrs. Harrigan purchased 100 shares of Meridian common stock on the open market at 8⅞ per share, but did not disclose her discussions with Mr. Mialki and Mr. Tarasi in connection with her dealings in the stock.

Mr. Sampas, the third plaintiff, is a member of the Florida bar engaged in the general practice of law. He declared in his deposition that his practice does not involve securities law matters. Mr. Sampas is also a long-time friend of Mr. Tarasi. In December of 1971, Mr. Sampas attended a luncheon with Mr.

Tarasi and Mr. Mialki, during which the Paragon-Meridian merger was mentioned. Sensing that a lucrative investment possibility existed, Mr. Sampas joined in the conversation. He avers that he also wanted to get additional information from Mr. Mialki because he believed that Mr. Tarasi knew very little about securities investments.

The ensuing discussion essentially repeated the information that Mr. Mialki had previously supplied to Mr. Tarasi. Mr. Mialki stated that a merger between Paragon and Meridian was imminent, and that executives of the Bank were making heavy investments in both corporations. He also said that although it was too late to purchase Paragon so as to reap the benefits of the merger, investment in Meridian was still a wise idea since its common stock would probably double in value.

Upon receiving such information, Mr. Sampas purchased a number of three-month "call" options for Meridian stock. During this period of time, Mr. Sampas kept in continuous communication with Mr. Mialki in order to learn when the merger would be consummated and when would be the best time to exercise his options. At every juncture, Mr. Mialki reassured him as to the prospects for the merger and for the appreciation in value of his investment.

As the time for the exercise of the options began running out, Mr. Sampas grew quite concerned because the merger had not taken place and he stood to lose his investment. He contacted Mr. Mialki, who advised him that the Securities and Exchange Commission had delayed the merger but that it would

surely go through. When Mr. Sampas asked whether Meridian's stock would increase in value, Mr. Mialki represented that it would.

Mr. Sampas then approached Shirley Wolff — a member of the law firm with which he was associated and an experienced investor in securities — and explained his predicament with regard to the "calls." Ms. Wolff agreed to purchase 1000 shares of Meridian, and Mr. Sampas promised to split any of his profits with her and to bear any of her losses.

In his deposition, Mr. Sampas averred that he realized that the information about the Paragon-Meridian merger which he had received from Mr. Mialki was in the nature of a "tip," and that Mr. Mialki had learned of the proposed merger through his position at that bank.

Mr. Sampas did not disclose his knowledge of the proposed merger when he purchased the "call" options nor did he divulge to Ms. Wolff what he knew of the proposed merger or the Bank's interest in it while arranging for her purchase of the Meridian stock. And this information was not revealed in connection with Ms. Wolff's purchase on the open market.

The merger between Paragon and Meridian did not occur,[6] and the value of the Meridian stock declined to about one dollar

6. Mr. Mialki, in his deposition, stated that he believed that the merger went through on an interim basis, but that it was later rescinded. He stated that he did not know the reasons for the recission. *See* App. at 63a-64a.

per share. Mr. Tarasi reimbursed Mrs. Harrigan for her losses,[7] and Mr. Tarasi and Mr. Sampas each purchased 500 shares of Meridian stock from Ms. Wolff at the price that she originally had paid for it. The present lawsuit was then filed in the Western District of Pennsylvania.

After extensive discovery, the defendants moved for summary judgment. In granting their motions, Judge Willson ruled that the plaintiffs were *in pari delicto* and thus could not recover, even if they could prove that Mr. Mialki had violated the securities laws. This appeal followed. And we now affirm the judgment of the district court.

II.

Initially, we are confronted with plaintiffs' contention that summary judgment was improper because disputed issues of material fact remained to be resolved.

It is true that several controverted factual matters existed at the time of Judge Willson's ruling. In particular, Mr. Mialki denied that he had told the plaintiffs about the Paragon-Meridian merger or that he had even recommended the purchase of Meridian stock.

Nonetheless, we are unable to agree with the proposition advanced by the plaintiffs. The inquiry mandated by Rule 56 is

7. It is possible that, on account of the reimbursement, Mrs. Harrigan no longer has a claim against the defendants. We do not, of course, express any opinion about that question.

not whether any issues of fact remain. Rather, it is whether issues of *material* fact are in dispute.[8] In this case, the contested issues of fact pertained to the question whether Mr. Mialki had violated the securities laws. But there was no disagreement as to the factual matters which bear on the defense of *in pari delicto*. This is so since it is undisputed that none of the plaintiffs made disclosure, in connection with their purchases of Meridian securities, of the inside information which they claimed they possessed.

The import of these considerations is that, if the defense of *in pari delicto* is applicable in securities fraud cases, Judge Willson did not err in concluding that the defendants would still be entitled to a verdict as a matter of law even if plaintiffs prevailed as to every disputed factual issue.

We thus turn to the central issue in this appeal — whether *in pari delicto* is a proper defense in suits brought under section 10(b) and rule 10b-5.

III.

In pari delicto, which literally means "of equal fault," is one of the common law doctrines fashioned to assure that transgressors will not be allowed to profit from their own wrongdoing.[9] Under this construct, a party is barred from

8. *See, e.g.*, Sound Ship Building Corp. v. Bethlehem Steel Co., 533 F.2d 96, 100 (3d Cir. 1976); Teamsters Local 249 v. Bill's Trucking, Inc., 493 F.2d 956, 964 (3d Cir. 1974); Kiess v. Eagen, 442 F.2d 712, 713 (7th Cir. 1971).

9. A companion principle is the equitable notion of "unclean hands."

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recovering damages if his losses are substantially caused by "activities the law forbade *him* to engage in."[10]

The rule has developed many complexities and has been applied where plaintiffs have had only a minimal association with the allegedly unlawful acts.[11] However, when *in pari delicto* is given a narrow interpretation, the scrutiny of the relative moral worth of litigants that it allows is a limited one. Only in those cases where it can fairly be said that the plaintiffs' fault is substantially equal to that of the defendant will recovery be precluded.[12] Moreover, a court may look only to conduct associated with the transaction before it, and may not forbid recovery on account of a plaintiff's activities in a separate setting.

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Under that doctrine, a party will not be able to obtain equitable relief if he himself has engaged in misconduct. *See, e.g.*, Precision Instrument Mfg. Co. v. Automotive Maintenance Machinery Co., 324 U.S. 800, 814-15 (1945); Keystone Driller Co. v. General Excavator Co., 290 U.S. 240, 244-45 (1933); Gaudiosi v. Mellon, 269 F.2d 873, 881 (3d Cir.), *cert. denied*, 361 U.S. 902 (1959). Since the plaintiffs in this appeal only seek damages, the "unclean hands" doctrine is not relevant.

10. Perma Life Mufflers, Inc. v. International Parts Corp., 392 U.S. 134, 154 (1968) (Harlan, J., concurring and dissenting) (emphasis in the original).

11. *Id.* at 138 (opinion of Black, J.); Note, *In Pari Delicto and Consent as Defenses in Private Antitrust Suits*, 78 Harv. L. Rev. 1241, 1242 (1965).

12. *See* Perma Life Mufflers, Inc. v. International Parts Co., 392 U.S. 134, 147-48 (Fortas, J., concurring); *id.* at 149) (Marshall, J., concurring); *id.* at 153-54 (Harlan, J., concurring and dissenting).

Because the doctrine occasionally has been applied in a sweeping fashion, it has been questioned whether *in pari delicto* is consonant with the mechanism of enforcement of regulatory statutes through private damage suits.[13] This issue, in the context of treble damage actions under the antitrust laws, came before the Supreme Court in *Perma Life Mufflers, Inc. v. International Parts Corp.*[14]

Perma Life was a suit brought by a number of Midas Muffler dealers against Midas and its parent corporation. Various antitrust violations were alleged. The focus of the litigation was the Midas dealership agreement, which contained provisions such as tie-ins, resale price maintenance, exclusive dealing arrangements and territorial restrictions, that purportedly abridged the antitrust laws.

The district court and the court of appeals[15] ruled for the defendants on the ground of *in pari delicto*. Since the plaintiffs had accepted the challenged agreement and had obtained benefits through their association with Midas, the trial and appellate courts reasoned that they would not be heard to assert that these contracts were tainted by illegality.

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13. *See, e.g.*, Note, *In Pari Delicto and Consent as Defenses in Private Antitrust Suits*, 78 Harv. L. Rev. 1241 (1965).

14. 392 U.S. 134 (1968).

15. Perma Life Mufflers, Inc. v. International Parts Co., 376 F.2d 692 (7th Cir. 1967).

Such reasoning was rejected by the Supreme Court. The case produced five opinions, with Justice Black authoring the lead opinion. Justice Black's starting point was his perception of "the inappropriateness of invoking broad common-law barriers where a private suit serves important public purposes."[16] *Perma Life* implicated this concern since the lower courts had apparently given *in pari delicto* a free-wheeling interpretation in applying it to the plaintiffs in that case. Although the conduct of the plaintiffs may have been "morally reprehensible," Justice Black continued, the provision in the Clayton Act for treble damages was strong evidence that Congress believed that enforcement of the national antitrust policy was paramount.[17]

Moreover, he added, the record in *Perma Life* suggested that the plaintiffs could not be said to be equally responsible for the illegal features of the dealership agreement. Plaintiffs merely acquiesced in the suspect provisions in order to gain the benefit of "an otherwise attractive business opportunity." And even if the plaintiffs had "supported" some of these clauses, the evidence showed that Midas was the driving force behind the restrictions.[18] Justice Black concluded by holding that "the doctrine of *in pari delicto,* with its complex scope, contents, and effects, is not to be recognized as a defense to an antitrust action."[19]

16. 392 U.S. at 138.

17. *Id.* at 138-39.

18. *Id.* at 139-40.

19. *Id.* at 140.

The clarity of this holding, however, was somewhat diluted by later portions of his opinion.[20] Justice Black recognized that the defendants had raised another argument, which he termed to be different and "considerably narrower."[21] It was contended that the plaintiffs should be barred from recovery since they had allegedly supported, in an active fashion, the entire anticompetitive apparatus of the dealership agreement. Justice Black, however, reserved the point "whether truly complete involvement and participation in a monopolistic scheme" could form the basis of a defense, since the facts of *Perma Life* in his judgment clearly did not present such a case.[22] The majority in *Perma Life* thus left open the possibility that the conduct of a plaintiff might erect a bar to recovery in suits brought under regulatory statutes.[23]

This conclusion would seem to be fortified by the four other

20. The difficulty in pin-pointing the precise implications of *Perma Life* has been noted by several commentators. *See, e.g.,* Sullivan, *Antitrust* 738-84 (1977); *The Supreme Court, 1967 Term,* 82 Harv. L. Rev. 63, 260-66 (1968). *But see* Comment, *The Demise of In Pari Delicto in Private Actions Pursuant to Regulatory Schemes,* 60 Calif. L. Rev. 572 (1972).

21. 392 U.S. at 140.

22. *Id.* at 140-41.

23. *See, e.g.,* Sullivan, *Antitrust* 783-84 (1977); Comment, *Securities Regulation: Doctrines of* In Pari Delicto *and Unclean Hands Held to Bar 10b-5 Recovery by Tippee Against Corporate Insider,* 1969 Duke L. J. 832, 838 (1969).

opinions in *Perma Life*.[24] They reveal that five Justices[25] explicitly concluded that they would hold, in some circumstances, that illegal conduct on the part of a plaintiff would prevent him from recovering. Although they differed in terminology, some wishing to retain the rubric of *in pari delicto* and some not,[26] these five Justices essentially agreed as to the rule they would apply: a plaintiff would be barred from obtaining damages in those cases where his fault was relatively equal to that of the defendant.[27]

Perma Life thus appears to have restricted consideration of plaintiffs' illegal conduct as a defense without foreclosing

24. 393 U.S. at 142 (White, J., concurring); *id.* at 147 (Fortas, J., concurring); *id.* at 140 (Marshall, J., concurring); *id.* at 153 (Harlan, J. concurring and dissenting).

25. Justice Stewart joined Justice Harlan's opinion.

26. Justice White agreed with the majority that "the *in pari delicto* defense in its historic formulation is not a useful concept for sorting out those situations in which the plaintiff might be barred because of his own conduct from those in which he may have been a party to an illegal venture but is still entitled to damages from other participants." *Id.* at 143 (White, J., concurring). He would rely, instead, on the concept of causation. *Id.* at 143-44 (White, J., concurring). The other concurring Justices would retain some form of the *in pari delicto* concept. *See id.* at 147 (Fortas, J., concurring); *id.* at 148-49 (Marshall, J., concurring); *id.* at 153-54 (Harlan, J., concurring and dissenting).

27. *See id.* at 146 (White, J. concurring); *id.* at 147-48 (Fortas, J., concurring); *id.* at 149 (Marshall, J., concurring); *id.* at 153-55 (Harlan, J., concurring and dissenting).

cognizance of this factor altogether. A plaintiff's unlawful conduct must be active and significant before it can bar a verdict in his favor. However, *Perma Life* also teaches that prevention of unjust enrichment and protection of the integrity of the courts cannot, by themselves, thwart recovery in private actions under regulatory statutes. Accordingly, before denying recovery to a plaintiff, a court must carefully assess the impact of such a result on the enforcement of statutory schemes.[28] This we shall now proceed to do.

IV.

Few cases have considered the ramifications of *Perma Life* upon the place of *in pari delicto* in private suits under rule 10b-5.[29] And the extant authorities are divided in the results they reach. The Fifth Circuit, in a line of cases beginning with

28. *See* Comment, *The Demise of In Pari Delicto in Private Actions Pursuant to Regulatory Schemes,* 60 Calif. L. Rev. 572, 575 (1972).

29. Several useful commentaries on this problem have appeared. See, *e.g.* Bell, *How to Bar an Uninnocent Investor-The Validity of Common Law Defenses to Private Actions Under the Securities Exchange Act of 1934,* 23 U. Fla. L. Rev. 1 (1970); Ruder, *Multiple Defendants in Securities Fraud Cases: Aiding and Abetting, Conspiracy,* In Pari Delicto, *Indemnification and Contribution,* 120 U. Pa. L. Rev. 597, 659-64 (1972); Comment, *supra* note 28; Comment, *supra* note 23; Comment, *Plaintiff's Conduct as a Bar to Recovery Under the* Securities *Acts:* In Pari Delicto, 48 Tex. L. Rev. 181 (1969); Comment, 40 Ford. L. Rev. 725 (1972); Comment, 33 U. Pitt. L. Rev. 103 (1971); Comment, 11 B.C. Comm. & Ind. L. Rev. 257 (1970); Comment, 58 Calif. L. Rev. 1149 (1970).

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Kuehnert v. Texstar Corp.,[30] has ruled that the doctrine of *in pari delicto* bars "tippee" suits against "tippers," whereas Judge Weinfeld of the Southern District of New York, in *Nathanson v. Weis, Voisin Cannon, Inc.*,[31] has concluded that the defense is inapplicable. The difficulty of our assignment in this case has been substantially alleviated by the careful analyses set forth by these tribunals.

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Section 1420(d) of the proposed Federal Securities Code of the American Law Institute would recognize the defense of *in pari delicto* in specified circumstances. Thus, before permitting the invocation of the defense under the proposed Code, a court should consider: (1) the deterrent effect of the particular type of liability; (2) the financial and legal sophistication of the parties; and (3) their relative responsibility for the loss incurred.

30. 412 F.2d 700 (5th Cir. 1969); *See also* James v. DuBreuil, 500 F.2d 155 (5th Cir. 1974).

One other case indicates that *in pari delicto* is available as a defense to private rule 10b-5 actions. In Wohl v. Blair & Co., 50 F.R.D. 89 (S.D.N.Y. 1970), Judge Mansfield denied a motion to strike the defense of *in pari delicto*, since the defense raised "serious and substantial legal issues." *Id.* at 93.

31. 325 F. Supp. 50 (S.D.N.Y. 1971).

32. Several other cases have considered whether *in pari delicto* is available in private suits brought under the securities laws. *See, e.g.*, Woolf v. S.D. Cohn & Co., 515 F.2d 591 (5th Cir. 1975), vacated and remanded, 426 U.S. 944 (1976) (10b-5 suit alleging failure to reveal that securities were not registered); Pearlstein v. Scudder & German, 429 F.2d 1136 (3d Cir. 1970), *cert. denied*, 401 U.S. 1013 (1971) (Regulation T); Serzysko v. Chase Manhattan Bank, 290 F. Supp. 74 (S.D.N.Y.), *aff'd per curiam*, 409 F.2d 1360 (2d Cir. 1968), *cert. denied*, 396 U.S. 904 (1969) (Regulation U); Can-Am Petroleum Co. v. Beck, 331 F.2d 371 (10th Cir. 1964) (suit under Securities Act alleging sale of unregistered securities).

Kuehnert and *Nathanson* present factual patterns relatively similar to the one before us here. "Tippees" were given inside information about certain corporations; they purchased securities in reliance thereon; they did not disclose the information that had been provided to them; the tips turned out to be misleading; and the "tippees" then sued their sources of information.

The *Kuehnert* court, in an opinion by Judge Aldrich,[33] held that such a suit was barred by *in pari delicto*. Judge Aldrich noted that "tippees," although not technically insiders, have a duty under rule 10b-5 to disclose any inside information when making a purchase or sale.[33a] He recognized, however, that in a strict sense, Kuehnert was not a "tippie" since the tip he had received was not accurate and he had not withheld material information from his vendors. Even so, Judge Aldrich concluded, this should make no difference inasmuch as the prohibitions of rule 10b-5 extended to attempted as well as consummated frauds. Moreover, but for the fortuity of the inaccuracy of the tip, Kuehnert would have succeeded in taking advantage of the unsuspecting sellers who had not been made aware of the inside information.[34]

33. Judge Aldrich was sitting in the Fifth Circuit by designation. His opinion was joined by Judge Dyer. Judge Godbold dissented in an opinion that presaged many of the arguments presented by Judge Weinfeld in *Nathanson*.

33a. SEC v. Texas Gulf Sulphus Co., 401 F.2d 833 (2d Cir. 1968).

34. 412 F.2d at 702-03.

Judge Aldrich then assessed the impact of *Perma Life,* and found it distinguishable on several counts. Suits by "tippees" against "tippers," he suggested, did not bear on the public interest to the same degree as antitrust treble damage suits since "tippee" suits merely concern "accounting[s] between joint conspirators."[35] Moreover, the *Kuehnert* court noted that *Perma Life* left open the possibility that "a true co-conspirator may be deprived of recovery even under the Sherman Act."[36] Judge Aldrich went on to urge that Kuehnert's conduct was of a different sort than the passive acceptance of illegality that the Supreme Court detected in *Perma Life.* Kuehnert's action in failing to disclose the inside information was active and voluntary and could not be attributed, as in *Perma Life,* to economic duress and unequal bargaining power.[37] Consequently, the court concluded, the case revealed the proper predicate for invocation of *in pari delicto.*

It was recognized, however, that under *Perma Life,* even this was not enough to bar a plaintiff's recovery without considering the effect of such a rule on the enforcement of public policy. The *Kuehnert* court stated that:[38]

35. *Id.* at 703. *See also* James v. DuBreuil, 500 F.2d 155, 160 (5th Cir. 1974).

36. 412 F.2d at 703.

37. *Id.* at 703-04.

38. *Id.* at 704.

> The question must be one of policy: which decision will have the better consequences in promoting the objective of the securities laws by increasing the protection to be afforded the investing public.

Disallowing the *in pari delicto* defense, the Court conceded, would have some effect in discouraging insiders from giving tips. However, suits by the SEC and ultimate purchasers and sellers had placed substantial pressure on insiders, and the paucity of "tippee" suits to that date had not stunted the efficacy of rule 10b-5.[39]

Moreover, the non-availability of *in pari delicto* would have a deleterious impact on securities law enforcement the Fifth Circuit stated. Under such a regime, it contended, a "tippee" would have in effect a warranty as to the truth of the information. If his tip were false he could recover damages from his informer. And if it were true, he would be able in all probability to retain his profits since his purchaser or seller would probably encounter insurmountable difficulties in tracing the "tippee." The *Kuehnert* court concluded that it would be best to deal with the "tippee" problem and to permit the invocation of *in pari delicto,* in order to place a restraint on the use of inside information by "tippees."[40]

39. *Id.* at 705.

40. *Id. See also* Wohl v. Blair & Co., 50 F.R.D. 89, 92-93 (S.D.N.Y. 1970).

In *Nathanson*, Judge Weinfeld examined the same factors that had been explored in *Kuehnert*. His scrutiny, however, departed from that of the Fifth Circuit in two important respects and thus yielded a different result.

First, Judge Weinfeld did not believe that "tippees" could be said to bear the same degree of fault as "tippers," which suggested to him that *in pari delicto* should not be applied to them under the principle of *Perma Life*. Equality of fault could not be found because "tippers," generally insiders, posed a greater threat to the investing public than "tippees." This is so, Judge Weinfeld claimed, since the "tipper" is "the fountainhead" of inside information and creates the possibility of "tippee" violations by making the initial disclosure.[41]

The critical position occupied by the "tipper" in the flow of inside information also shaped Judge Weinfeld's second variance from the analysis set forth in *Kuehnert*. His assessment of the impact on enforcement of the securities laws of the allowance or disallowance of *in pari delicto* was somewhat different from that put forward by Judge Aldrich. Although recognizing the damage that "tippees" could inflict on the investing public, Judge Weinfeld stated that the most appropriate reaction would be to place maximum pressure on insiders by not permitting *in pari delicto* as a defense. This, he asserted, would discourage the initial release of inside information and would thus nip in the bud the potentiality of further violations.[42]

41. 325 F. Supp. at 57.

42. *Id.* at 57-58.

With the opinions by Judges Aldrich and Weinfeld forming the backdrop, we now turn to our own analysis of the problem presented by the case at hand.

V.

Our first task is to determine whether the unlawful conduct of the plaintiffs here is of sufficient magnitude, when compared to the derelictions of the defendants, to establish the predicate for the application of *in pari delicto*. We conclude that it does.

There is no dispute regarding the nature of the securities law violations committed by the plaintiffs. As "tippees", they were under an obligation either to make full disclosure before engaging in transactions on the open market or to refrain from trading until such information was made public.[43] And it is clear that they did not reveal the possibility of a Paragon-Meridian merger. Moreover, there has been no intimation that the plaintiffs' conduct in purchasing Meridian securities and not making disclosure was anything but voluntary.

Mr. Mialki and the Bank, in contrast, have allegedly committed two distinct violations of rule 10b-5. The first is the one of which plaintiffs complain — namely, the purportedly false and misleading statements made by Mr. Mialki about the

43. *See, e.g.*, Shapiro v. Merrill, Lynch, Pierce, Fenner & Smith, Inc., 495 F.2d 228 (2d Cir. 1974); SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 848 (2d Cir. 1968), *cert. denied sub. nom.* Kline v. SEC, 394 U.S. 976 (1969); Ross v. Licht, 263 F. Supp. 395, 410 (S.D.N.Y. 1967); A. Bromberg, *Securities Law: Fraud, SEC Rule 10b-5* 190.13-190.20 (1973); 3 L. Loss, *Securities Regulation* 1451 (1961).

Paragon-Meridian merger. The other is the illegality against which we must measure the conduct of the plaintiffs: the selective release of inside information to a chosen few "tippees."

Perma Life provides the framework for this discussion. The opinions in that case establish the rule that a plaintiff may be deprived of a recovery only if his fault is substantially equal to that of defendant.[44] Applying this yardstick to the somewhat different context of suits brought under rule 10b-5, though, is not a simple assignment.

Antitrust cases in which defendants seek to invoke *in pari delicto* provide relatively straightforward settings for measuring the relative fault of the parties. The plaintiff, as in *Perma Life*, has ordinarily done business with the defendant and is party to an agreement with the defendant. Such agreement is usually the basis of the alleged illegal conduct of both parties, and the issue to be resolved is whether the plaintiff involuntarily assented to the illicit arrangement or whether he actively participated in the formulation of the unlawful scheme.[45]

Securities cases such as the one before us do not usually fit into this mold. The infractions of the parties — the release of inside information by the "tipper" and its use by the "tippee" —

44. *See* note 27 *supra*.

45. *See* Sullivan, *Antitrust* 783-84 (1977); Note, *In Pari Delicto and Consent as Defenses in Private Antitrust Suits*, 78 Harv. L. Rev. 1241 (1964).

are linked,[46] but they are not based upon an agreement between the parties. Since it is ordinarily not alleged that the defendant coerced the plaintiff into entering into securities transactions, and since comparisons of bargaining power are irrelevant, it is more difficult to give content to the notion of equality in such a context.

In our view, however, the reasons behind the adoption of the equality benchmark suggest that the plaintiffs and the defendants here should be deemed to be of substantially equal fault in causing the loss of which plaintiffs complain. It is true that the parties are not co-conspirators in the usual sense, since a joint program of illegal conduct was never agreed upon or even contemplated.[47] Nonetheless this litigation contains an important element, absent in *Perma Life*, that, we believe, makes it an instance of joint participation in wrong-doing — specifically, voluntary illegal conduct on the part of the plaintiffs.

46. This is not to suggest that use of inside information by "tippees" is a prerequisite, in all contexts, for a finding of "tipper" liability. *See* A. Bromberg, *Securities Law: Fraud, SEC Rule 10b-5* at 190.9-190.10 (1973). However, it is through the use of inside information that the evil that rule 10b-5's prohibition against tipping aims to prevent — unequal access to material information — is visited upon the general investing public.

47. James v. DuBreuil, 500 F.2d 155 (5th Cir. 1974) did present a suit under rule 10b-5 where the parties could be considered co-conspirators. As Judge Ainsworth noted in his opinion, see *id.* at 160, a situation such as that provides the strongest case for invocation of *in pari delicto*.

Perma Life emphasized the fact that the participation by the plaintiffs in the unlawful agreement was passive, and perhaps coerced.[48] Applying *in pari delicto* to such plaintiffs would not at all serve the purposes of the antitrust laws, since no deterrence of future violations could be expected while the effectiveness of treble damage actions might be undermined.[49]

The fact that the plaintiffs in this case willingly committed illegal acts would seem to obviate these concerns to a substantial degree. Deciding that "tippees" might be said to be *in pari delicto* with "tippers" is not necessarily repugnant to the aims of the securities laws. Indeed, as we shall indicate, it would actually have the effect of deterring "tippee" violations. Moreover, it should be noted that the voluntary illegal activities of the plaintiffs present a serious threat to the investing public, which the securities laws seek to prevent. Finally, the voluntary acts of the plaintiffs may fairly be said to be a sine qua non of their losses: but for their purchases of Meridian securities, they would not have suffered any injury. Thus, we conclude that the prohibited conduct of the plaintiffs is of sufficient magnitude and has a sufficient causal relation with their losses to bring into play the concept of *in pari delicto*, as it was refined by *Perma Life*.[50]

48. *See* 392 U.S. at 140-41; *id.* at 147 (White, J., concurring); *id.* at 148 (Fortas, J., concurring). *See generally*, Note, *In Pari Delicto and Consent as Defenses in Private Antitrust Suits*, 78 Harv. L. Rev. 1241 (1965).

49. *See* 392 U.S. at 142-47 (White, J., concurring).

50. In his opinion in *Nathanson*, Judge Weinfeld suggested that the (Cont'd)

This, however, does not complete our inquiry. For *Perma Life* teaches that *in pari delicto* should not be applied mechanically when the public interest is present. Rather, it is necessary to assess the impact upon the enforcement of a regulatory system before sanctioning its application. After careful deliberation we conclude that the considerations in this case are sufficiently distinct from *Perma Life* so as to allow the invocation of the doctrine of *in pari delicto* against the "tippees" here.

The *Perma Life* situation was one in which the element of enforcement pointed to the inapplicability of *in pari delicto*. Its use, in such circumstances, would not serve to deter potential lawbreakers and would reduce the pool of private attorneys general.[51] In the instant case, however, the concern of

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degrees of fault attributable to "tippers" and "tippees" cannot be said to be equal. The crux of his position appears to be the contention that "tippers," being the "fountainhead" of inside information, pose a greater danger to the investing public than do "tippees." *See* 325 F. Supp. at 57.

Although we acknowledge that this factor is relevant in determining whether application of *in pari delicto* is consonant with enforcement of public law norms, we do not believe that it is apposite in measuring relative degrees of fault. It is true that the inquiry as to equality of fault is informed to some degree by enforcement considerations. But the focus in our view should be a narrower one, concentrating on the extent to which the acts of plaintiffs and defendants can be said to be substantial causes of the injury suffered by the plaintiffs.

51. *See* The *Supreme Court, 1967 Term*, 82 Harv. L. Rev. 63, 260-66 (1968).

enforcement cuts both ways. Both the defendants and the plaintiffs have contravened rule 10b-5 and a decision to disallow *in pari delicto* will have some deterrent impact on potential "tippers," while its application could lessen the possibility that a "tippee" will use such information in an illegal manner. The question before us, as indicated by the *Kuehnert* and *Nathanson* courts, is which alternative will best serve the policies that undergird the securities laws.[52]

Barring *in pari delicto* and allowing a "tippee" to recover, would have the effect, to some degree, of creating an additional reason for those possessing inside information not to give tips. This is so since insiders would be aware that if their tips turned out to be inaccurate, they could be liable to the "tippees."[53] Judge Weinfeld, in *Nathanson*, insisted that such was the preferable course since it places pressure on the source of inside information. This strategy, if successful, would diminish the problem of "tippee" violations, since the "tipper" would be discouraged from initiating the first step in the chain, the issuance of the tip.[54]

52. We recognize, of course, that this analysis must, to some degree, rest upon non-verifiable observations about the effects of a particular legal rule.

53. *See* Nathanson v. Weis, Voisin, Cannon, Inc., 325 F. Supp. 50, 57-58 (S.D.N.Y. 1971); Comment, *The Demise of In Pari Delicto in Private Actions Pursuant to Regulatory Schemes*, 60 Calif. L. Rev. 572, 593-94 (1972).

54. 325 F. Supp. at 57-58. After Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976), however, such liability is limited to cases where it is shown that the defendant acted with scienter.

Although the argument is not without strength, the enforcement pressure that non-recognition of *in pari delicto* would engender through incremental deterrence of "tippers" is, in our judgment, outweighed by the prophylactic impact on the use of inside information that allowance of the defense will lead to.

Elimination of *in pari delicto* would not seem to augur a substantial reduction in the flow of inside information. The absence of this defense would have the greatest impact on deliberate purveyors of false information since they would be liable to "tippees." The result of authorizing "tippee" recoveries against tippers, who believe their tips to be true, is less certain. Particularly in light of the holding in *Ernst & Ernst*[54a] that a showing of scienter is a prerequisite to private recoveries under rule 10b-5, it is questionable whether such "tippers" would be forestalled from spreading inside information by the threat of "tippee" suits. Thus, "tippee" suits would not appear to provide a particularly effective tool with which to abate the flow of inside information.[55]

In contrast, permitting *in pari delicto* could have a more telling effect on "tippee" conduct. As Judge Aldrich noted in *Kuehnert*, the danger of eliminating *in pari delicto* is that such a

54a. Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976).

55. *See* Comment, *Securities Regulation: Doctrines of* In Pari Delicto *and Unclean Hands Held to Bar 10b-5 Recovery by Tippee Against Corporate Insider*, 1969 Duke L.J. 832, 839 (1969).

stance would give "tippees" almost no incentive to forebear from using inside information. This is so since if the suggested purchase proved unprofitable, the "tippee" might have recourse against his "tipper" on account of the inaccurate leak.[56] The threat of application of *in pari delicto* would eliminate the warranty of the accuracy of the tip that might otherwise exist.[57]

Moreover, sanctioning *in pari delicto* and thus opting for additional enforcement pressure on "tippees" rather than upon "tippers" would not substantially detract from the aim of discouraging "tippers" from releasing inside information. As *Kuehnert* pointed out, substantial deterrents to "tippers" are provided by the possibility of SEC and criminal actions and private suits by non-"tippee" purchasers and sellers who have been adversely affected by the dissemination of inside information.[58] And enforcement of the securities laws against putative "tippers" by means of private suits will not be impaired to any great extent since suits by "tippees" are relatively infrequent, especially when compared to the volume of rule 10b-5 suits brought by other classes of plaintiffs.

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56. It should be noted that this suit would be subject to the scienter requirement enunciated in *Ernst & Ernst.*

57. See Kuehnert v. Texstar Corp., 412 F.2d 700, 704-05 (5th Cir. 1969); Wohl v. Blair & Co., 50 F.R.D. 87, 92-93 (S.D.N.Y. 1970); Comment, *Securities Regulation: Doctrines of* In Pari Delicto *and Unclean Hands Held to Bar 10b-5 Recovery by Tippee Against Corporate Insider*, 1969 Duke L. Rev. 832, 839-40 (1969).

58. See 412 F.2d at 705.

Finally, in an instance such as here where the enforcement equities are equally balanced, we believe it not improper to take into consideration the factors that form the basis of *in pari delicto:* augmenting the integrity of the courts and preventing wrongdoers from profiting from their misdeeds.[59] Such a course is, in our view, compatible with *Perma Life.* Although Justice Black's opinion expressed doubt whether denying a plaintiff recovery on account of recreant conduct could be squared with the Congressional mandate for private enforcement of the antitrust laws, he held in abeyance the issue whether some private actions might be barred on account of plaintiff's conduct. And five other Justices clearly stated that some plaintiffs would be unable to recover on account of their actions.

The *Perma Life* opinions thus indicate that a limited application of *in pari delicto* can be harmonized with enforcement of the securities laws. Indeed, the case for invocation of this defense would seem to be stronger in the context of the securities laws than in the antitrust field. This is so because private suits under the antitrust laws are provided for by statute while private causes of action under rule 10b-5 are judicially implied. Although private damage actions are important instruments for enforcing the securities laws, [60] it

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59. *See* Perma Life Mufflers, Inc. v. International Parts Corp., 392 U.S. 134, 151 (1968) (Marshall, J., concurring); *id.* at 154 (Harlan, J., concurring and dissenting); Note, *In Pari Delicto and Consent as Defenses in Private Antitrust Suits*, 78 Harv. L. Rev. 1241, 1242 (1965).

60. *See* J.I. Case Co. v. Borak, 377 U.S. 426 (1964).

would appear to be more appropriate to engraft limited judicially-fashioned defenses onto judicially-implied causes of action as opposed to Congressional enactments.

We hold, therefore, that *in pari delicto* stands as a bar to the present lawsuit. Accordingly, the judgment of the district court will be affirmed.

TO THE CLERK:

Kindly file the foregoing opinion.

Circuit Judge

DATED:

APPENDIX B — MEMORANDUM

IN THE UNITED STATES DISTRICT COURT FOR THE WESTERN DISTRICT OF PENNSYLVANIA

WILLIAM TARASI, GEORGE SAMPAS and VIRGINIA R. HARRIGAN,

Plaintiffs

vs.

PITTSBURGH NATIONAL BANK and S. ROBERT MIALKI

Defendants.

(C.A. No. 74-1078)

(Filed May 20, 1976)

WILLSON, Senior District Judge

This Court has under consideration motions of the defendants for summary judgment pursuant to Rule 56. Attached and made a part hereof is Appendix A, which consists of Paragraphs 6 through 14 inclusive of the complaint. The sixth paragraph of the complaint alleges the jurisdiction. Even a casual reading of those paragraphs indicates that the plaintiffs seek the protection of the several provisions of the Securities Exchange Act and the regulations of the Securities Exchange Commission as a basis for recovery against the two defendants. Paragraph 8 alleges that the defendants " . . . were insiders who because of their special relationship, had access to information not available to the plaintiffs or to the general public . . . . "

Paragraph 12 clearly avers that as a result of the disclosures made by defendant, Mialki, plaintiffs purchased shares of the Meridian stock.

It is apparent from the deposition affidavits taken of each of the individual plaintiffs that they were tippees as to the same inside information, which they allege to have secured from the defendants and with the result that they bought the shares of stock. The merger not having taken place, they claim relief from the defendants.

In considering the motions for summary judgment, filed by the defendants, this Court has reviewed the pleadings, the depositions of the plaintiffs, and has examined the briefs filed by counsel. The conclusion of this Court is that defendants are entitled to summary judgment. This Court but seldom adopts the reasoning in toto in a brief filed by counsel for the litigants, but in this case the brief filed by B.A.Karlowitz, Esq., and Orlando R. Sodini, Esq., of the law firm of Tucker, Arensberg & Ferguson covers the factual situation as developed in the depositions and is an exposition of the law on this subject. It is believed that counsel have stated the law as well as the Court could if not better. In any event, this Court adopts the brief of the defendants as a memorandum and the law in this case. Each of the decisions cited by counsel in the brief has been examined. Therefore, based upon the pleadings and giving due consideration to the depositions and especially the testimonial statement by plaintiffs, they were tippees under the facts developed in this case. This Court finds that there is no genuine issue as to any material facts and that the moving parties, the defendants, are entitled to judgment as a matter of law.

ORDER FOR JUDGMENT

AND NOW, *May 20, 1976,* for the reasons stated in the foregoing memorandum, including the allegations of the complaint in Appendix A and the brief in Appendix B, each of the defendants' motions for summary judgment is granted and judgment is entered against each plaintiff and in favor of each defendant. This civil action is dismissed.

IT IS SO ORDERED.

s/ Joseph P. Willson
JOSEPH P. WILLSON
Senior District Judge

cc:
Louis M. Tarasi, Jr., Esq.
B.A. Karlowitz, Esq, and Orlando R. Sodini, Esq.
Carl W. Brueck, Jr. Esq.

Appendix "A" Attached to Memorandum.

* * *

6. This action arises under and jurisdiction is based upon §10(b) of the Securities Exchange Act of 1934 (15 U.S.C.S. §78J(b) and Rule 10(b)-5 of the Securities Exchange Commission. (17 C.F.R. §240 10(b)-5).

7. At the time of the transactions hereinafter mentioned Meridian Industries, Inc. had shares of stock which were registered, and traded on the American Stock Exchange, a National Securities Exchange and Paragon Plastics, Inc. was a Pennsylvania Corporation with which it was to merge.

8. At the time of the said transactions, defendants, S. Robert Mialki and Pittsburgh National Bank, were insiders who because of their special relationship, had access to information not available to the plaintiffs or to the general public in regard to the above noted Meridian Industries, Inc. and Paragon Plastics, Inc.

9. On or about December 19, 1971, S. Robert Mialki, defendant herein, met with William Tarasi, Geroge Sampas, and at a later date with Virginia R. Harrigan, plaintiffs herein and stated to them that he "anticipated a merger between Meridian Industries and Paragon Plastics" and he and "some of the downtown executives of Pittsburgh National Bank", defendant herein, "had purchased large amounts of both Paragon Plastics and Meridian stock".

10. At the aforesaid meetings, S. Robert Mialki stated that "some of these downtown executives purchased lots of 10,000 shares of Paragon Plastic stock", that although it was too late to purchase the Paragon stock, the Meridian stock was available for purchase and was being sold for $8.00 or $9.00 a share, and that it would probably jump to $16.00 or $17.00 a share when news of the merger became public.

11. At the aforesaid meetings, S. Robert Mialki also told William Tarasi, George Sampas and Virginia R. Harrigan, that the merged corporations would have further financial backing and that he would inform Mr. Sampas, Mrs. Harrigan, and Mr. Tarasi of the most opportune time to purchase the said stock.

12. As a result of Mr. Mialki's disclosures, George Sampas, William Tarasi and Virginia R. Harrigan purchased certain amounts of shares of Meridian stock using various means of interstate commerce to effect the purchases.

13. No merger ever came about between Paragon Plastics and Meridian Industries and as a result of Mr. Mialki's false and misleading statements, acting as the agent, workman, servant and employee of the defendant, Pittsburgh National Bank, Virginia R. Harrigan suffered a total trading loss of approximately $1,000.00, George Sampas suffered a total trading loss of approximately $6,000.00. William Tarasi, as a result of the aforementioned circumstances, suffered a total trading loss of approximately $15,000.00.

14. Were it not for the fraudulent and false statements and misrepresentations of the defendant, S. Robert Mialki, as agent, servant, workman, and employee of Pittsburgh National Bank, as alleged above, plaintiffs would not have purchased these shares of stock.

Appendix "B" Attached to Memorandum.

IN THE UNITED STATES DISTRICT COURT
FOR THE WESTERN DISTRICT OF PENNSYLVANIA

WILLIAM TARASI, GEORGE SAMPAS, and VIRGINIA R. HARRIGAN,

Plaintiffs

vs.

PITTSBURGH NATIONAL BANK and S. ROBERT MIALKI,

Defendants

CIVIL ACTION NO. 74-1078

BRIEF OF PITTSBURGH NATIONAL BANK IN SUPPORT OF ITS MOTION FOR SUMMARY JUDGMENT

FACTS

On November 6, 1974, the plaintiffs filed the Complaint against Pittsburgh National Bank ("PNB") and S. Robert Mialki ("Mialki"). The Complaint alleges that PNB, acting through its agent, servant and employee, Mialki, violated §10(b) of the Securities & Exchange Act of 1934 and Rule 10(b)-5 adopted thereunder. The plaintiffs alleged that Mialki, who at the time was an officer of PNB and manager of its Verona office, made certain misrepresentations to the plaintiffs. The alleged

misrepresentations included statements to the effect that Meridian Industries, Inc. ("Meridian") and Paragon Plastics, Inc. ("Paragon") were about to merge and as a result of the merger the price of Meridian, which was traded on the American Stock Exchange, would increase. It is alleged by the plaintiffs that Mialki misrepresented to them that PNB was behind the merger. In reliance on these misrepresentations plaintiffs purchased shares of stock in Meridian, but because the merger never occurred, they suffered a total trading loss of approximately Twenty-two Thousand ($22,000) Dollars. In addition to the compensatory damages the plaintiffs are seeking two million, five hundred thousand dollars in punitive damages.

Even if all the plaintiffs' allegations are proven the plaintiffs are barred from any recovery based on the equitable doctrine of in pari delicto and the broader doctrine of unclean hands.

As is evidenced by their own depositions the plaintiffs violated §10(b) of the S.E.C. Act and Rule 10(b)-5, by: (1) failing to disclose to their respective vendors the inside information they allegeedly received from Mialki, or (2) by failing to abstain from buying Meridian in the open market until the inside information became public knowledge, or (3) by recommending the purchase of Meridian while the inside information remained undisclosed.

Plaintiff, George Sampas ("Sampas"), specifically violated §10(b) and Rule 10(b)-5, by failing to reveal to his vendor, from whom he purchased call options, the inside information he received from Mialki and in addition by recommending the

purchase of Meridian stock to his law partner with whom he agreed to split any profits.

Sampas purchased 10 call options on Meridian stock after receiving the alleged inside information from Mialki. (Sampas Deposition, pp. 10-11) Because his options were quickly running out, Sampas agreed with his law partner, Shirley Wolff, that if she would purchase the stock, Sampas would guarantee any losses and would split any profits. (Sampas Deposition, p. 14) Upon the recommendation of Sampas, Ms. Wolff purchased 1,000 shares of Meridian in her name. (Sampas Deposition, p. 15)

Sampas testified in his deposition that he did not reveal any of the inside information he received from Mialki to his broker, vendor or Ms. Wolff. Sampas Deposition, p. 29:

> Q. Did you pass all of this information on to Shirley Wolff when you and she made that agreement?
>
> A. No.
>
> Q. Did you tell Shirley anything about this information that you had received from Mr. Mialki or anybody else pertaining to Meridian and Paragon?
>
> A. No.

> Q. Did you disclose any of this information to Wallston & Company (Brokers) at their Miami Branch when you made the buys?
>
> A. No.
>
> Q. Did you make any effort to disclose this information to the people from whom you purchased the options in April, 1972, this information which you said you had obtained?
>
> A. Not that I recall. I first put a call order in. I don't recall any conversation with them.

Sampas, an attorney and member of the Florida Bar knew or should have known that his actions were a clear violation of the Securities and Exchange Act of 1934.

Plaintiff, William Tarasi ("Tarasi"), also breached his duty to the investing public by purchasing Meridian stock while in possession of inside information and by recommending the purchase of Meridian stock to plaintiff, Virginia Harrigan.

Tarasi admitted in his deposition that after receiving the inside information from Mialki, Tarasi authorized Mialki to purchase Meridian stock in Tarasi's name. (Tarasi Deposition, pp. 14-15) In addition, Tarasi, on several occasions, recommended to Virginia Harrigan that she also purchase Meridian stock. (Tarasi Deposition, p. 27).

Virginia Harrigan in her deposition, concurred in the fact that Tarasi recommended that she purchase Meridian. Harrigan Deposition, p. 8:

> A. Mr. Mialki and Skip (Tarasi) came in and I was alone and Skip was talking about stock and I said, 'Oh, that sounds interesting.' Skip said, 'Oh you ought to buy some' . . .
>
> Q. Do you recall what stock Skip Tarasi was talking about?
>
> A. Meridian.

Finally, Plaintiff, Virginia Harrigan, purchased shares of stock in Meridian, in her name. (Harrigan Deposition, pp. 13-14) Having purchased the stock while in the possession of inside information and not disclosing this information to her broker and vendor, plaintiff Harrigan breached her duty to the investing public and is in violation of §10(b) and Rule 10(b)-5.

ISSUE

Whether the plaintiffs, themselves having traded on inside information and violated §10(b) of the Securities & Exchange Act of 1934 and Rule 10(b)-5 adopted thereunder, are barred from recovery based on the affirmative defense of in pari delicto and the broader doctrine of Unclean Hands.

DISCUSSION

Even if the plaintiffs clearly establish a prima facie case against the defendant, PNB, for violating §10(b) and Rule 10(b)-5, their Complaint should be dismissed based on the affirmative defense of *in pari delicto*. The appropriate relief is to grant PNB's Motion for Summary Judgment.

It is well established that tippees have a duty to the investing public just as insiders and if that duty is breached they are in violation of §10(b) and Rule 10(b)-5. See, *Shapiro v. Merrill, Lynch, Pierce, Fenner & Smith, Inc.*, 495 F.2d 228 (2nd Cir. 1974).

The tippees' duties to the investing public were first established in *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833 (2nd Cir. 1968):

> "Anyone in possession of material inside information must either disclose it to the investing public or, if he is disabled from disclosing it . . . must abstain from trading it or recommending the securities concerned while such inside information remains undisclosed." 401 F.2d 848

The plaintiffs, as tippees, clearly breached their duty as first established by the Court in *Texas Gulf Sulphur Co.* In breaching their duty owed to the investing public the plaintiffs

placed themselves in a position of being in pari delicto with PNB and are barred from any recovery.

The leading case on the application of the doctrine of *in pari delicto* in §10(b) and 10(b)-5 actions, and one that presents a factual situation similar to the present case, is *Kuehnert v. Texstar Corporation,* 412 F.2d 700 (5th Cir. 1969). In *Kuehnert, the Fifth* Circuit affirmed the District Court's granting of defendant's motion for summary judgment based on the defense of in pari delicto.

The plaintiff, Kuehnert, alleged that W.T. Rhame, a former president of Texstar, informed him of a pending merger between Texstar and Coronet Petroleum Company and of the fact that Texstar had made some "secret" discoveries. Rhame informed Kuehnert that he expected the price of Texstar to "enormously increase." In reliance upon this information Kuehnert purchased a substantial amount of Texstar stock on the open market through brokers without personal knowledge of the identity of the sellers.

The Court noted that although Kuehnert was not strictly an "insider", he was a "Tippee" and obliged to make disclosures to the sellers.

In granting defendant's Motion for Summary Judgment the court stated at page 703:

> "We have small doubt but that actual illegal conduct should bar recovery. It is true that in certain areas exceptions may exist, as for example, anti-trust. [citations] The guiding principal is one of policy. In private SEC violates [sic] the degree of public interest is not comparable to that made apparent by the triple damage provision; we see no sufficient public interest when the only question is one of accounting between joint conspirators. This view is supported by the availability of an unclean hands defense in actions involving SEC proxy requirements.

The application of the defense of in pari delicto rests with the discretion of the court and as noted by the Court in *Kuehnert* the objectives of the SEC Act of 1934 are best served by permitting this defense, at pages 104-05 the Court stated:

> "Although Kuehnert's status as a tippee makes the defenses of unclean hands and *in pari deli to* available, their application rests with the discretion of the court. [citations]
>
> The question must be one of policy: which decision will have the better consequences in promoting the objective of the securities laws by increasing the protection to be afforded the investing public. [citations] . . . It is true that if a tippee has no remedy against an insider's private falsehoods, little deterrent against such conduct will exist; the insider may have free rein. But, as

against this, there is another danger. If a tippee can sue he has, in effect, an enforceable warranty that secret information is true. It is then he that will have free rein. If what he is told is false, he can recover against his informer. If it is true, he will, of course, be liable to his vendors or vendees, but here he may well be protected by the difficulties of discovery. It may be relatively easy to trace insiders; tippees are another matter.

The growth of 10b-5 actions has not thus far been handicapped observably by the absence of suits by tippees against insiders. Nor do we believe that *in pari delicto* and unclean hands have limited the effectiveness of the proxy regulations. Therefore, in view of the substantial deterrent pressures already felt by the corporate insider, *SEC v. Texas Gulf Sulphur Co., supra,* we think it important that tippees, who present the same threat to the investing public as do insiders themselves, should be offered appropriate discouragement. We conclude that the better choice is to leave upon persons believing themselves tippees the restraint arising from the fear of irretrievable loss should they act upon a tip which proves to have been untrue. hence the loss must lie where it falls. [footnote omitted]

The holding in the *Kuehnert v. Texstar Corporation* case was extended in *Wohl v. Blair & Co.,* 50 F.R.D. 89 (S.D.N.Y. 1970) to cover a tippee who acted to his detriment on information, believed to be inside information, which he received from a broker who was not himself an insider.

In *Wohl,* plaintiffs sued a broker, claiming they had made stock purchases based upon false tips supplied by him. Plaintiffs attempted to distinguish *Kuehnert* on the ground that the plaintiff in Kuehnert was in fact an "insider" or "tippee" because he received his false information directly from the president of the corporation, whereas the plaintiffs in *Wohl* received it indirectly through the defendant who had in fact been in communication with the president of the company. In rejecting this distinguishment the court held at pages 92-93:

> "We are also not impressed by plaintiffs' further argument that extension of the *Kuehnert* holding would erode or destroy the effectiveness of the antifraud statutes by enabling brokers to feel free to defraud their customers with impunity as long as they couch their fraudulent representations in terms of "inside information." As long as there are customers eagerly looking for "tips" based on "inside information," there will be registered representatives playing to their desire to make a profit at the expense of someone not equally informed. Without condoning the conduct of any such broker-dealers, it may well be that much of the excessive and inflationary

speculation in securities is attributable to customers seeking information which they are not entitled to have unless and until it is freely available to all. One possible solution may be the adoption of a form of '*caveat tippee*' policy. If such customers learn that they accept 'inside information' at their own risk, many may decide that it is better to reject proffers of such information and to play the game according to the laws and SEC rules enacted for their protection than to risk loss of their hard-earned capital."

The principles enumerated in *Kuehnert v. Texstar Corporation* (supra) and *Wohl v. Blair & Co.,* (supra) were reaffirmed by the Fifth Circuit in *James v. Du Breuil,* 500 F.2d 155 (5th Cir. 1974). In *James v. Du Breuil,* the Fifth Circuit affirmed the District Court's decision granting judgment for the defendant after presentation of plaintiff's case. After quoting extensively from *Kuehnert v. Texstar Corporation,* (supra) the court stated at page 160:

> "If plaintiff was duped in the process, it is not our role to serve as referee in an accounting between co-conspirators. To do so would not increase the protection afforded the investing public." [footnote omitted]

Barring the uninnocent investor from suit is not a new concept in securities regulations. See, *Gaudiasi v. Mellon,* 269

F.2d 873 (3rd Cir. 1959), cert. denied 361 U.S. 902 (1959); *Rosenberg v. Hand,* 121 F.2d 818 (3rd Cir. 1941). The Third Circuit in *Gaudiosi* stated at page 882:

> "Courts in such situations act for their own protection and not as a matter of "defense" to the defendant. Public policy not only makes it obligatory for courts to deny a plaintiff relief once his "unclean hands" are established but to refuse to even hear a case under such circumstances. Thus, it has been held that even in a stockholders' derivation action "unclean hands" on the part of the plaintiff will require dismissal of the action." [footnote omitted]

See also, *Ehrler v. Kellwood Company,* 391 F.Supp. 927 (E.D. Missouri 1975); *Chris-Craft Industries, Inc. v. Independent Stockholders Committee,* 354 F.Supp. 895 (D. Del. 1973).

The In-Pari-Delicto defense has been used to bar plaintiffs' suits based on alleged violations of regulations T and U. In *Serzysko v. Chase Manhattan Bank,* 290 F.Supp. 74 (S.D.N.Y. 1968), aff'd per curiam, 409 F.2d 1360 (2nd Cir. 1968) cert. denied, 396 U.S. 904 (1969), plaintiff sued for damages caused by loans allegedly made to him in violation of regulation U. The Court noted that since the plaintiff had induced the wrong he should be denied relief:

> "It is the view of the Court that to allow the plaintiff to recover in this action would be to encourage rather than discourage deception on the part of investor-borrowers with resulting prejudice to the observance of the margin requirements of the Act." 290 F.Supp. 74 at p. 89-90.

It has been suggested by some authorities that the defense of in pari delicto should be unavailable to a tippor in an action by a tippee under §10(b) and Rule 10(b)5, based on the theory that the policies and objectives of the securities law can best be advanced by stopping the flow of inside information at its source. It is argued that if the tippee is permitted to sue the tippor, individuals would be less willing to disclose any inside information they may possess. See, *Nathanson v. Weis, Voisin, Cannon, Inc.*, 325 F. Supp. 50 (S.D.N.Y. 1971).

However, the more reasoned approach has been to deny recovery based on the defense of in pari delicto. See, 1969 Duke L.J. 832. To hold otherwise would place the tippee in a position of "heads, I win, tails, you lose." If the stock, which the tippee purchased on inside information, goes up in price the tippee can sit back and enjoy the fruits of his illegal conduct all to the disadvantage of the unknown investor from whom he purchased the stock on the open market. However, if the stock goes down in price, he can sue his tippor and recover his losses.

Denying the defense of in pari delicto gives the tippee a "sure bet" and would have little, if any, effect on halting the flow

of inside information. It is rather easy to trace insiders, but tippees are another matter.

On the other hand, placing the risk of loss on the tippee would discourage trading on inside information and at the same time *protect the unknown innocent investor* who trades on the open market.

The essential question to ask is,

> "Which decision will have the better consequence in promoting the objective of the securities law by *increasing the protection to be afforded the investing public. Kuehnert v. Texstar Corp.*, (supra) at p. 704" [emphasis added].

In *Woolf v. S.D. Cohn & Company*, 515 F.2d 591 (5th Cir. 1975), the fifth Circuit reaffirmed its holding in *Kuehnert v. Texstar Corp.*, (supra), but, based on the particular facts in the case, the Court denied the application of the defense of in pari delicto. However, *Woolf* is distinguishable on a number of grounds.

Woolf involved an action against a partnership registered as a broker-dealer under the Securities Exchange Act. The plaintiffs sought to recover the purchase price they had paid for certain convertible debentures, which they subsequently converted into shares of common stock. The plaintiffs alleged that they were induced to participate in the "private placement" of debentures, which were not registered under the S.E.C. Act of

1933, by certain misrepresentations of material facts made by the defendants. The defendants argued that the plaintiffs were in violation of the S.E.C. Act by concealing from the issuer and the defendants the fact that they were purchasing the debentures for a number of individuals other than themselves. In rejecting the defense of in pari delicto, the Court placed heavy emphasis on the fact that the defendants' alleged violation of the S.E.C. Act involved material misrepresentations in connection with the distribution of unregistered securities, while the plaintiffs' violation was only technical in nature and was not of the type that affected the general investing public.

The Court noted at page 605:

> ". . . the instant case, involved the distribution of unregistered securities by issuers who hoped their activities would fall within the §4(2) exemption from representations under the 1933 Act . . . it is the responsibility of the issuer and its agent or underwriter seeking the advantages of the exemption from registration to see to it that all the requirements for the private placement exemption are met. . . . *Indeed, it is in this context that the private suit is particularly appropriate,* because an issuer claiming exemption does not file with the S.E.C. the detailed information required for registered securities and is not subject even to the scrutiny accorded these filings by the S.E.C. staff . . .

> Therefore, in many instances, particularly those involving relatively small distributions, *the private suit is the only effective means of detesting and deterring wrongdoing* on the part of the issuers and their agents or underwriters who have not registered the securities being offered for sale." [emphasis added]

Because no legitimate objective or policy of the securities act would be furthered, the Court in *Woolf* correctly denied the application of the defense of in pari delicto. However, the Court in *Woolf* clearly recognized the applicability of the defense of in pari delicto in factual situations similar to that presently before this Court.

CONCLUSION

The plaintiffs, by purchasing shares of stock in Meridian, while in the possession of inside information and by recommending to others that they purchase Meridian, while such information remained undisclosed, have violated §10(b) and Rule 10(b)-5. This violation has placed the plaintiffs in a position of being *in pari delicto* with the defendant.

The application of this defense is within the sound discretion of the Court. *Kuehnert v. Texstar Corp.,* (supra). By permitting PNB to invoke the defense of *in pari delicto* this Court will be promoting the objectives of the securities law by increasing the protection to be afforded the investing public. Unless the plaintiffs' claims are dismissed the plaintiffs will have

managed to place themselves in a position of having a "sure bet", all to the disadvantage of the investing public.

It is respectfully requested that this Court grant PNB's Motion for Summary Judgment.

Respectfully submitted,

s/ B.A. Karlowitz
B.A. Karlowitz

s/ Orlando R. Sodini
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